

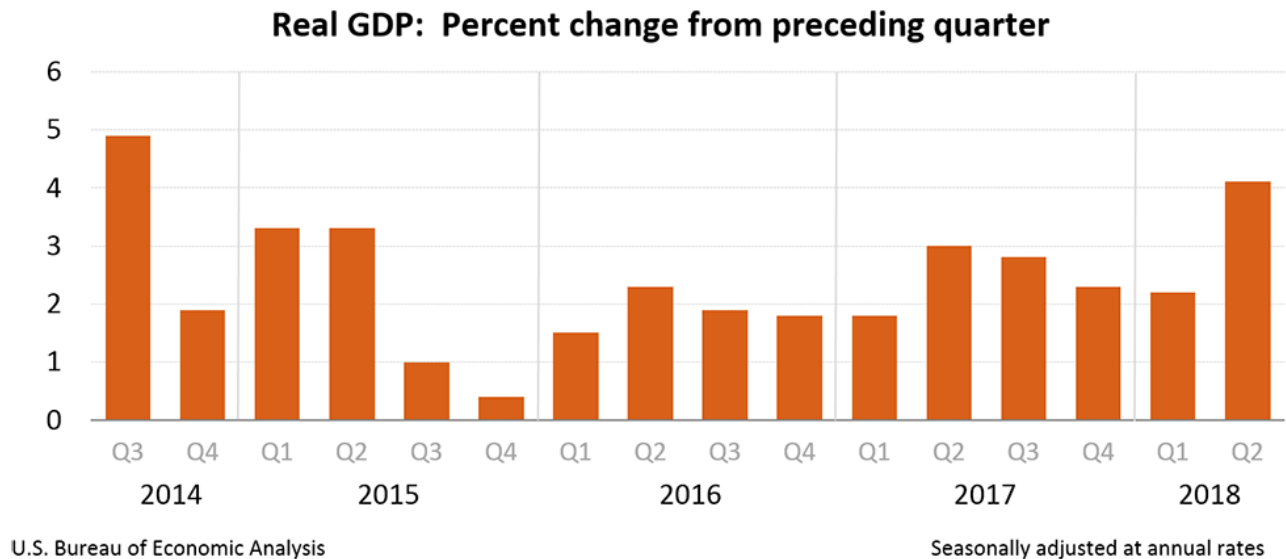
Stillwater Capital - This Week in the Markets



The Top- Down

The Commerce Department provided the first look at second quarter GDP this morning. And a good look it was, growing at 4.1%. The strongest in almost four years as consumer spending and business investment led the way.

GDP



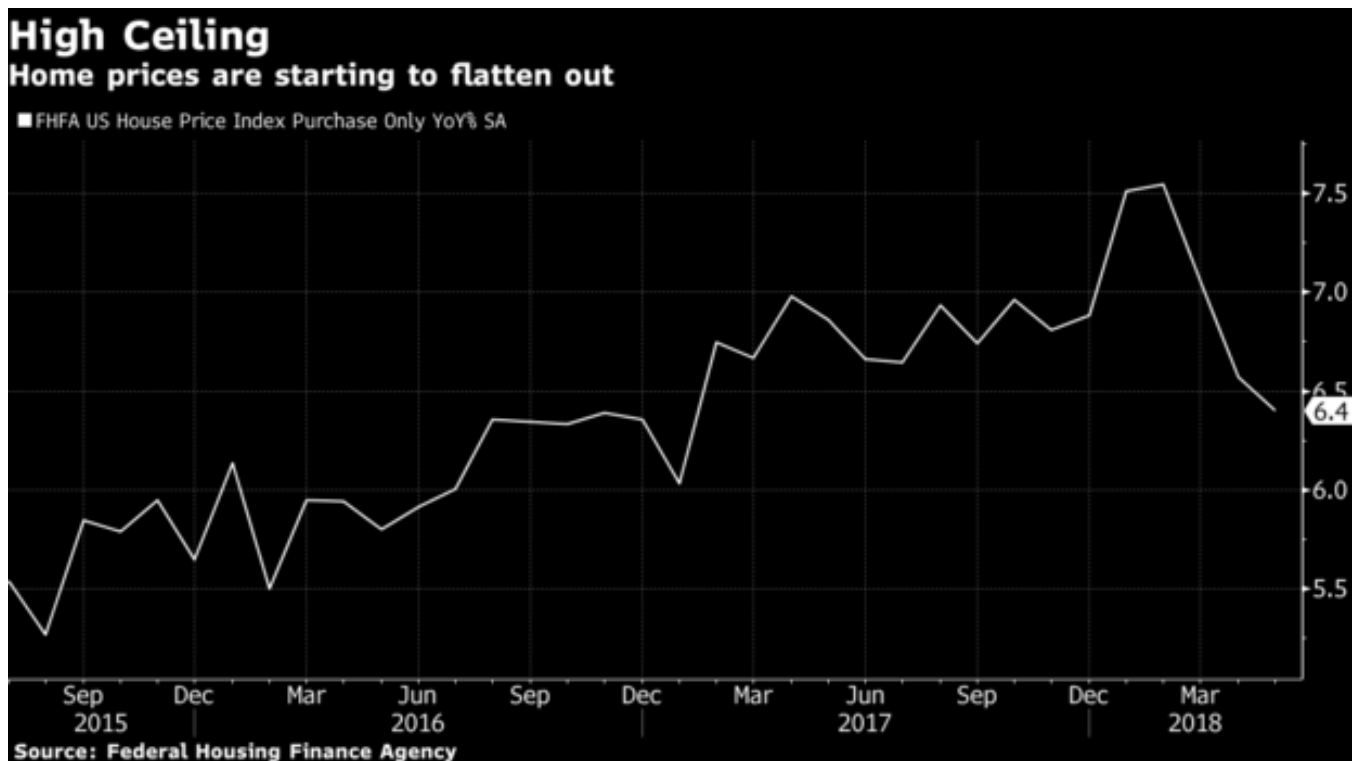
The only unnerving thing about the reports is that both President Trump and his National Economic Advisor Larry Kudlow couldn't seem to keep their mouths shut and foreshadowed a big number earlier in the week.

The Stillwater View: This was indeed a big number and portends higher stock prices and momentum for the Trump agenda. Barring an outside event, the near term risk is that inflation plays along with growth and we will get a spike in yields.

We would only ask of the administration that they don't mess with markets by signaling their hand ahead of time with news they know would impact asset prices. But we aren't holding our breath.

The housing market is showing signs of transitioning from a one way seller's market to a more balanced position. The headline from *Bloomberg* titled the "The US Housing Market is Looking For its Worst Slowdown in Years" highlights a concern that high prices are disconnected from house value and affordability. Add to that the concern that the cost to borrow is going up, and suddenly you have a "different market" as brokers like to say. Bloomberg provided a couple of great charts to highlight the changes.

On Prices...



On Inventory...

Taking Inventory

Homebuyers are suddenly seeing more options on the market

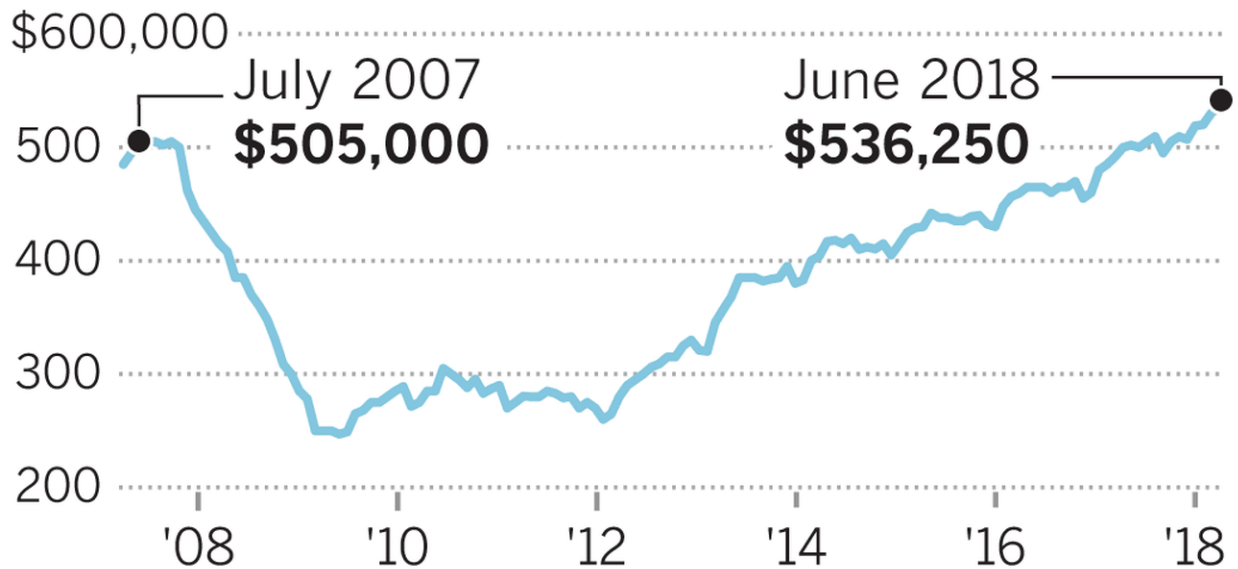


The Stillwater View: It's an unwritten rule that everyone loves a good chart, and we certainly have embraced that mantra. That being said, we also love correlations. If price trends in real estate and the equity markets continue to track each other, January 2018 could prove to be the near-term top in asset prices.

In other real estate news *CNBC* ran a headline that “Southern California Homes Sales Crash”. That was a bit deceiving as the *volume* of transactions “crashed” 12%, but prices went up a robust 7% year-over-year.

Fully Recovered

Southern California median home prices



Source: CoreLogic

@latimesgraphics

The man who navigated Blackstone's stunning success in residential real estate, Jonathan Grey, has turned the firm's focus to warehouses. The tailwind? The simple yet very basic premise that as online sales grow, warehousing, logistics, and transportation of goods is going to continue to grow with it.

Amazon Fulfilment Center



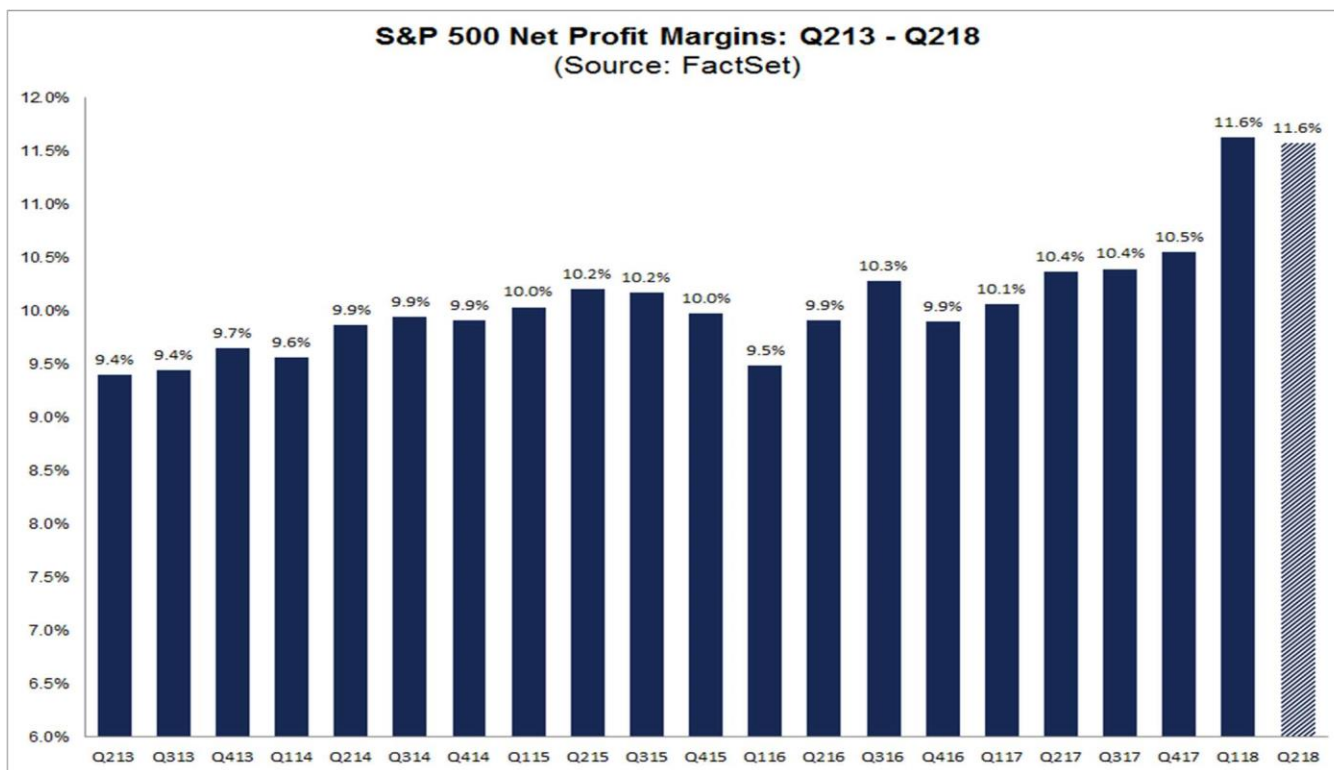
Source: Amazon

The Bottom-Up

The second quarter earnings wave continues to roll in, and by and large it validates the fact that corporate profits are the strength holding this market together. And even if they are not venturing into a more positive territory they are indeed plateauing at a very high level.

The current 11.6% net profit margin expected for the full Q2 matches last quarter and is the highest since FactSet started keeping score in 2008. If earnings come through as expected, Q3 and Q4 will set new high water marks at 11.8% for net profit margins.

Margin Strength



The Stillwater View: Hard to say much of anything bad except that we hope this earnings growth isn't fully baked into the market. As we have mentioned previously, earnings are key to keeping this game going into extra innings. Continued upside versus consensus goes a long way to validate that trend and the market bias will remain upward.

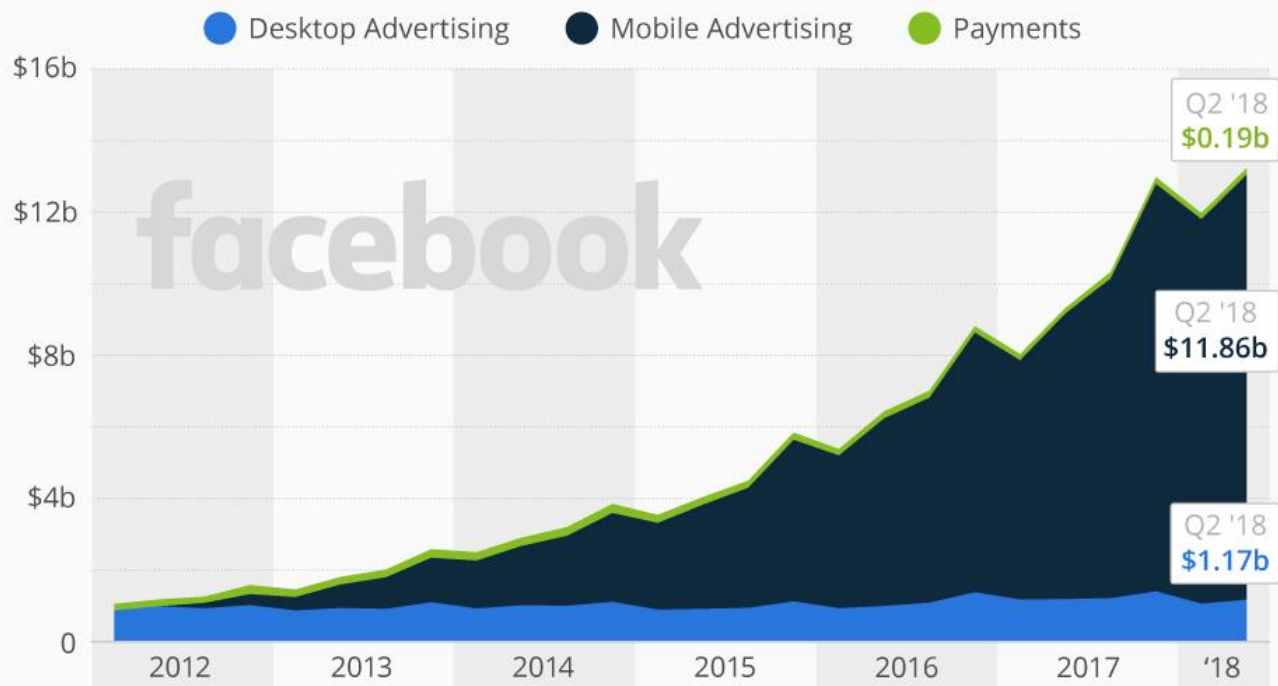
Facebook coughed up the biggest hairball in market history on Thursday when the company missed expectations on several key metrics, including top-line revenue and active daily users. To give you an idea of the sheer magnitude of the rapid change in fortune, CFO David Wehner disclosed that the current 44% operating margin would drop to the “mid-30s” for the next two years. A number that was 47% just one ago.

Bottom line, challenges of their own making finally caught up with Facebook and now it costs a whole lot more to run the company.

Revenue Up, Margins Headed Down

Facebook's Growth Is Fueled by Mobile Ads

Facebook's quarterly revenue by segment



@StatistaCharts Source: Facebook

statista

Every business news outlet out there made space to chronicle the fall of Facebook. *Business Insider* called it an “earnings disaster”. *CNBC* provided granularity and then stretched it a bit when they wrote how the selloff “could impact your finances”. Finally, *Bloomberg* profiles how recent scandals have taken their toll on usage and includes an interview with Brian Wieser of Pivotal Research, one of the few Facebook bears on Wall Street.

User Growth Slows

Underperforming User Growth Facebook's monthly active user growth slows

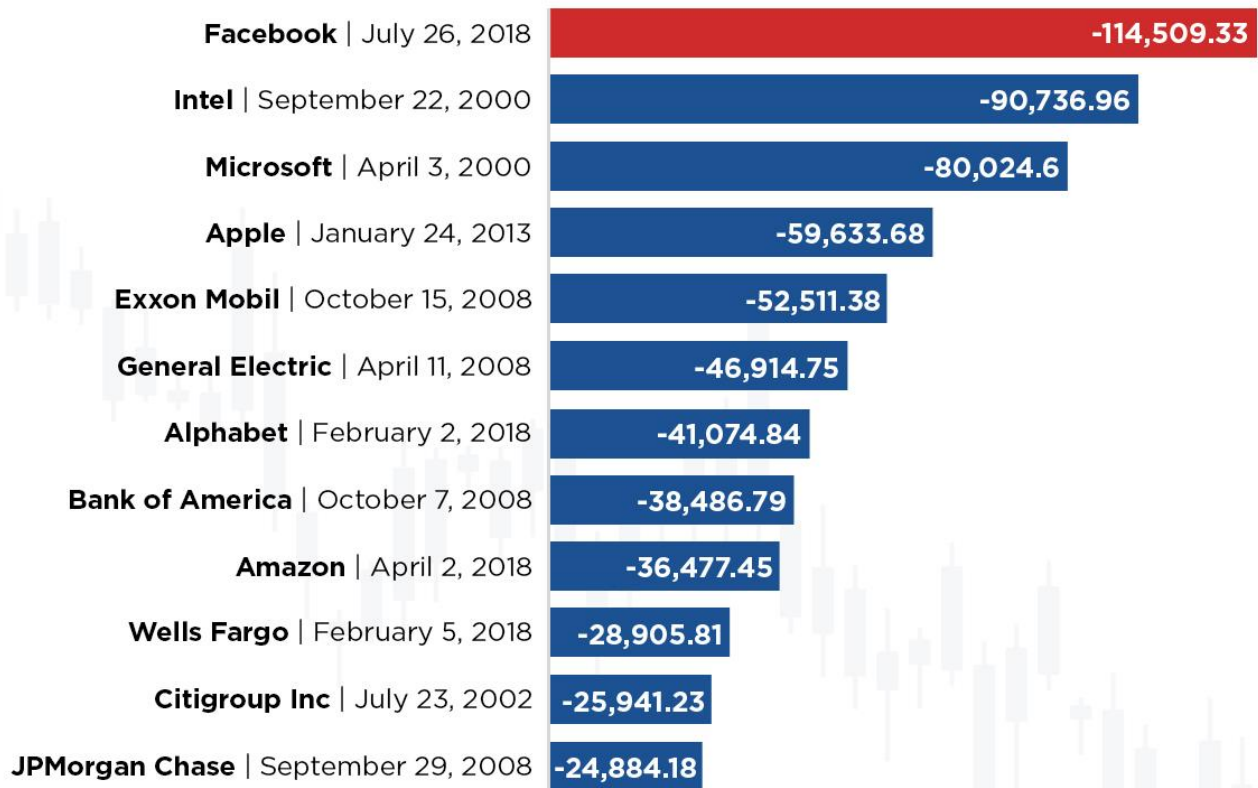


As was widely reported, the \$115 billion loss in value was the biggest in stock market history.

Biggest Blowups on Record

Market cap losses in big cap stocks

(U.S. DOLLAR LOSS IN BILLIONS)



Source: FactSet

The Stillwater View: Wall Street is stunned? I'm stunned that they're stunned!

Maybe it was the quick rebound in the stock price after last quarter that led the market to believe Cambridge Analytica didn't matter. Or perhaps more simply there was general hubris among shareholder's and analysts that "Mark and Sheryl would just figure it all out."

Regardless of the reason, I think the bulk of investors didn't truly know what they owned and paid a price when whatever music they were listening to stopped playing..

Stillwater held a short position in Facebook largely on the belief that issues around privacy were going to have a negative fundamental impact on user growth and community usage. The fact that it showed up so fast was the only surprise. As *Business Insider* profiled yesterday, Mark Zuckerberg told the market what was going to happen three months ago.

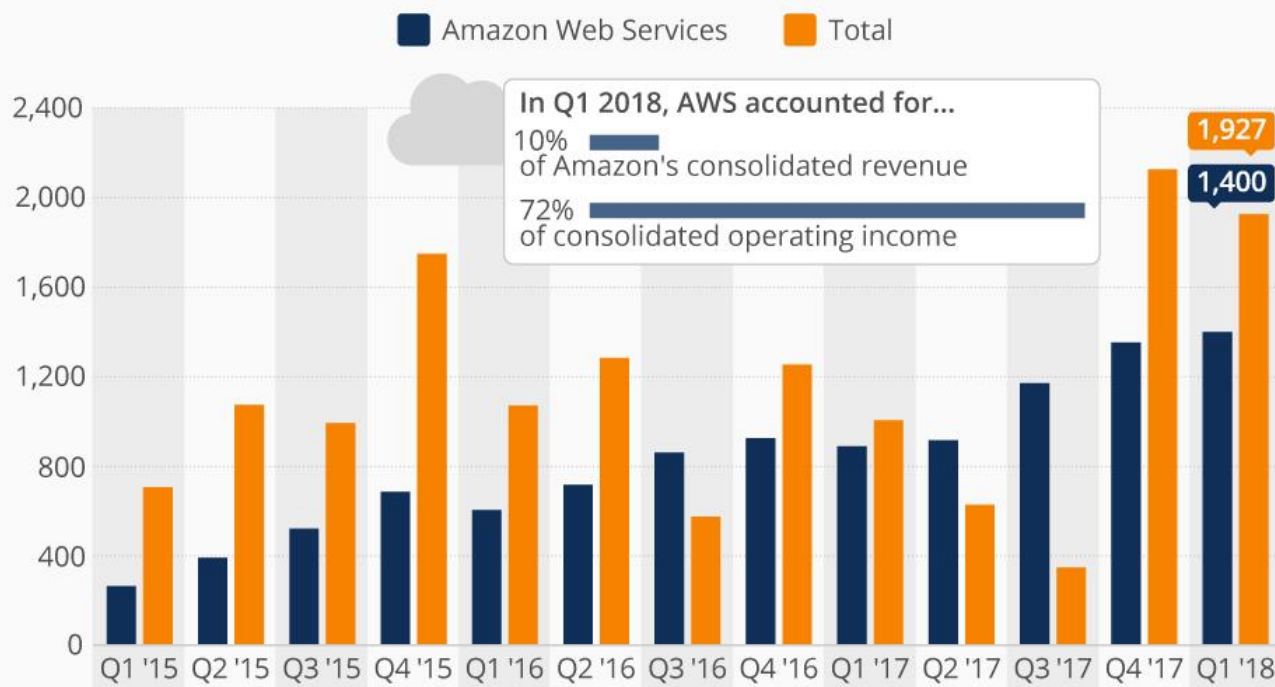
In the Stillwater Trinity hedged equity strategy, the short position contributed nicely to our 100 basis point day yesterday. While the broad market was down 25 bp. That's a win. And most every hedge fund and actively managed growth mutual fund we know of was long Facebook going in. That's another win.

The market breathed a sigh of relief yesterday after the close when Amazon reported numbers that were light on revenue and heavy on earnings. Amazon Web Services was the upside driver, growing 44% year-over-year. To give you an idea on how good the outlook is for the company, they raised expectations for operating income to \$2.4 billion in Q3. Well above the consensus of \$1.5 billion. And AWS is nothing shy of a profit making machine.

AWS Powering the Amazon Profit Ship

Cloud Business Still Drives Amazon's Profits

Amazon's quarterly operating profit (in million U.S. dollars)



The Stillwater View: It's tough to say much more about the situation at Amazon except that they are accelerating into higher altitudes with clearer air every day. This quarter once again validated that momentum has no intention of slowing down.

Similar to what Jack Nicklaus once said of a young Tiger Woods, "Amazon is playing a game that Wall Street is not familiar with" Stillwater is long the shares and will start to trim back when it reaches the 10% threshold we set on maximum position size.

Up & Down Wall Street

As was reported in Financial Planning magazine, the RIA business reached a milestone this week when Focus Financial (Symbol: FOCS) saw a successful public offering of its shares. After some back and forth with the underwriters, the shares priced at \$33 and traded up to \$37.55 to close out the day. A nice 13.75% first day pop for insiders and new shareholders.

The event was significant for a few reasons. First, no stand-alone Registered Investment Advisor has made a go of it in the public markets before. Second, in spite of the fancy verbiage that Focus is an "asset aggregator", at the end of the day it's a rollup. And rollups have had a spotty record in the public market. Screw up an acquisition and the bloom quickly fades from the rose. Finally, what does the success of this IPO say about the valuations, the influx of private equity money, and the prices they are paying as well as the current state of the RIA world?

Focus Financial

A private equity deal valued the firm at \$2 billion in 2017.

Age: 12 years

Partner firms: 50+

Stated revenue: \$700 million

Total deals closed in 2017: 25+

Market valuation: \$2 billion

Source: Company data

The Stillwater View: Those of us in the RIA business frequently ask ourselves this question “how is this consolidation game going to end”. To a certain extent, we just found out.

Recently, a colleague and I were having this conversation. And when asked why does everyone want in on the RIA wave right now, my response was that with fee compression creeping in on all sides, the revenue advisors generate is some of the most stable on Wall Street. In addition, the value that investment counsel provides isn't going away soon. Robo advisors be damned!

All hedge funds have a “woobie”, and it should come as no surprise that for many it goes by the name Amazon. With Facebook in the penalty box for the foreseeable future, it's has become increasingly important that the shares of AMZN continue to move higher.

CNBC is calling FAANG the “worlds most crowded trade”, which we believe to be true. This also means it needs to hold itself together or the broader market is indeed at risk. Lose the kind of leadership that large cap technology has provided, and look out below.

Narrowing Leadership



Lee Cooperman, a Wall Street legend from the golden age of hedge funds, is taking his money out of Omega Advisors and will be running it under the umbrella of his own family office. Lee's best quote to describe the move came from Kenny Rogers when The Gambler sang “You've got to know when to hold em'. Know when to fold 'em.” Omega assets have dropped from roughly \$10 billion five years ago to \$4 billion today. Omega is up 6% this year..

Cooperman on CNBC







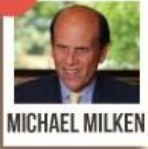
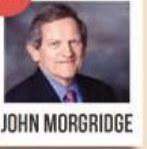
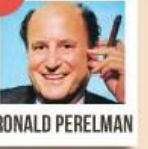
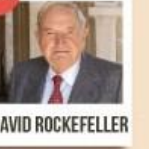




Cooperman went on to note that the Gambler “clearly didn’t follow his own advice”. Rogers “acknowledged that at almost 80, he shouldn’t be performing any longer, but that he’d been divorced four times and needed the money.” Fortunately for Lee, he doesn’t need the money. Warren Buffet sent a congratulatory message and thanked him for joining the Giving Pledge. When Buffett asked for a 50% commitment of his assets, Cooperman doubled it.

Others Who Have Pledged

THE *Giving* PLEDGE

Warren Buffett's goal for his Giving Pledge is to give away 99% of his wealth during his lifetime. Americans billionaires, other than Bill Gates and Warren Buffett, who have taken the Giving Pledge since 2010 include the following:

#196  ELI BROAD \$6.9B, investments	#1372  STEVE CASE \$1.2B, AOL	#466  JOHN DOERR \$3.4B, venture capital	#731  BARRY DILLER \$2.4B, online media	#5  LARRY ELLISON \$48B, Oracle	#295  GEORGE LUCAS \$4.9B, Director, producer
#687  MICHAEL MILKEN \$2.5B, investments	#1565  JOHN MORGRIDGE \$1B, former Chair, Cisco Systems	#73  RONALD PERELMAN \$14B, leverage buyouts	#580  DAVID ROCKEFELLER \$2.9B, oil, banking	#796  TED TURNER \$2.2B, cable TV	#21  MARK ZUCKERBERG \$28.5B, Facebook

Source: Value Walk

Dan Loeb continues to struggle to stay in the black this year. His Third Point Advisors offshore fund is up 0.80% through the end of the second quarter. Still, at \$18 billion under management his views are worth listening to.

A copy of the [full letter](#) to his clients was reprinted by *Value Walk* this week. Stillwater provides the abbreviated highlights.

View of the current economic backdrop:

- 1) US growth will remain buoyed at a high level due to the fiscal stimulus.
- 2) Inflation has remained stable...despite a record low unemployment rate.
- 3) The cycle can extend longer than many people think
- 4) Equities are not expensive at 16x forward earnings

And what could upset the apple cart:

- 1) A trade war
- 2) Tougher and tougher growth comps
- 3) Increasing signs of inflation given how strong employment has been

PayPal was [profiled](#) in the letter as his best new idea. In the letter he says that the world's largest processor of on-line payments is misunderstood by Wall Street and that as the "new" company emerges, investors will begin to take notice. He sees the stock valued at \$125 in the next 18 months.

Roughly a 35% premium from where it trades today. So far Wall Street is not impressed. The shares sold off 5% this week on news that Venmo growth continues to slow.

PayPal Outpacing the S&P 500 in 2018



The Stillwater View: Loeb has produced some of the better returns in the hedge fund arena and only appears to be stalled out for now. He has been calling for a potential consolidation or correction on the horizon, aside from a tough February earlier this year, it really hasn't materialized. His performance most likely took a hit in July, as Facebook and NXP Semiconductor are companies he owns.

Diversions

The Tour de France rolls on through the French mountains en route to Paris on Sunday. As NPR reports, defending champ Chris Froome has had a tough go of it this year. Earlier in the week he was pulled from his bike by a police officer who mistook him for a race crasher. That was after he was accidentally tear gassed.

While the action on the course is still very exciting, it has become slightly less so since the retirement of the jumping Red Devil four years ago. Dieter "Didi" Senft still makes quieter cameo appearances at the race. One where he became a ubiquitous figure for over twenty years.

"El Diablo"



Source: Cyclist Magazine

Rock and Roll icon Mick Jagger turned the big Seven Five yesterday. Yes, you read that right. Mick is now five short years away from becoming an octogenarian. Age is not slowing the man down as he fathered his eight child two years ago at the tender age of 73.

Mick Jagger



Source: Digital Spy

The Stillwater View: While the list is long for the best of Mick and the Rolling Stones, our favorite remains “Dead Flowers” and the legendary 1972 live performance in Dallas.

Later tonight the longest lunar eclipse of the 21st century will take place. The bad news is that only our European and Asian readers will get the change to experience it. The “Blood Moon”, as it is called, will last a good two hours. And Mars will be riding shotgun.

The “Blood Moon” Rising



Source: Phys.com

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